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IN THE SUPREME COURT OF THE UNITED STATES

October Term, 1968

No. 41

SECURITIES AND EXCHANGE COMMISSION,

Petitioner,

vs.

NATIONAL SECURITIES, INC., ET AL.,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT
OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR NATIONAL SECURITIES, INC., ET AL.

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Opinions Below

The opinion of the District Court (App. 139-44) is reported at 252 F. Supp. 623. The opinion of the Court of Appeals (App. 148-61) is reported at 387 F.2d 25.

The judgment of the Court of Appeals was entered on November 14, 1967 (App. 162). The petition for certiorari, filed on

March 4, 1968, within time duly extended by Justice Douglas on February 10, 1968, was granted on April 22, 1968 (App. 163). This Court has jurisdiction under 28 U.S.C. § 1254(1).

Question Presented

We cannot agree that the "question presented" as offered by the Government is the question actually presented to and decided by the court below. We therefore restate the question as follows:

Whether § 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5 issued thereunder, read in the light of the McCarran-Ferguson Act, apply to allegedly false and misleading statements made in soliciting stockholder consents to a merger of insurance companies where the same matters, under applicable State statutes, have been before the Arizona State Director of Insurance who has approved the merger.

Statutes And Rules Involved

The relevant provisions of the McCarran-Ferguson Act, 59 Stat. 33-34, 15 U.S.C. §§ 1011-1015; § 10(b) of the Securities Exchange Act of 1934, 48 Stat. 881, 15 U.S.C. § 78j(b), and Rule 10b-5 of the General Rules and Regulations under the Securities Exchange Act of 1934, 17 C.F.R. 240.10b-5; the relevant provisions of the Securities Acts Amendments of 1964, 78 Stat. 565, 15 U.S.C. § 78l(g), and 78 Stat. 569, 15 U.S.C. § 78n (1964); and of the several applicable provisions of the statutes of Arizona are set forth in Appendix A. to this brief.

Statement

A. The Parties, Their Transaction, and the SEC Complaint.

This case involves National Producers Life Insurance Company (National Producers), which is in fact one of the largest life insurance companies incorporated in Arizona. The company is the product of a merger which occurred in 1965, and it is that merger which gives rise to this action. In April, 1964, National Securities, Inc. (National Securities) held a controlling interest

in an Arizona insurance company, National Life and Casualty Company (National Life). National Securities bought a substantial block of stock in a second Arizona insurance company, Producers Life Insurance Company (Producers). The stock of National Life and the stock of Producers were traded over-the-counter and neither was registered on any national securities exchange.

The details of the purchase agreement are immaterial here. Since the case was decided on a motion for judgment on the pleadings, we merely note that the pleadings are in conflict. The SEC claims that National Securities bought stock from a group of principal shareholders of Producers, and that it did so contemplating a consolidation of National Life and of Producers. It alleges that the selling parties undertook not to compete with Producers or any resultant company, and that this obligation was later put upon the consolidated company; which, by paying for the non-compete agreements, would thus be paying a portion of the cost of acquiring the interest in Producers.

While the complaint uses strong conclusory language, reflected in the Government's brief here, pp. 3 and 4, with its talk of "an illegal scheme" and violation of "the antifraud provisions of the Act," we have not understood the Commission, in this Court at least, to have any complaint of the *terms* of the agreement by which National Securities purchased the Producers stock. That is to say, there is no contention here that the price was unfair or the terms were somehow illegal or inequitable. Obviously, any purchase in which there are to be continuing payments involving a possible later merger or consolidation will commonly involve the utilization of funds of the company being acquired. The contention of the Commission is, rather, that there were inadequate disclosures in the proxy solicitation attendant upon the later merger; for subsequent to the 1964 purchase, there was

a merger of the two insurance companies.¹ A vigorous proxy fight occurred over the merger; there was a hard-hitting proxy solicitation campaign on both sides; see e.g. App. 46, 60, 117, *et seq.*

As synopsised in its brief here, the Complaint of the Commission, duly challenged in the Answer, was that the defendants, in soliciting support for the merger, either misinformed or inadequately informed the Producers shareholders in four respects:

1. The SEC alleges that the proxy solicitation made clear to the voters that the non-compete agreements would be assumed by the surviving corporation but did not disclose the dollar amount of this assumption (Amended Complaint, paras. 22-23, App. 90-91; Answer, paras. 22-23, App. 105).

2. The SEC alleges that the company forecast a net income of the reorganized company, before taxes, of \$460,000 for the year 1965, which is said to be *per se* misleading and to fail to disclose past losses (Amended Complaint, paras. 28, 33, App. 94-95; Answer, App. 105, 106.)²

3. The SEC alleges that the company included in its *pro forma* balance sheet an asset said to be "illusory" (Amended Complaint, para. 27, App. 93-94). The company answers that the particular figure in controversy had been "authorized expressly by the Insurance Commissioner of Arizona in writing for this general purpose," and that the use made was "permissible

¹ This was not the transaction which was contemplated in April, 1964, when the non-compete agreements were made. Originally, National Securities agreed to manage Producers at a guaranteed profit (App. 33); so that Producers would become a majority-owned subsidiary, it was then contemplated that Producers shareholders would acquire National Securities stock (App. 27-30). But, due to stockholder dissatisfaction, the management agreement was cancelled; for reference by way of allusion, see R. 126. The merger proposal for National Life and Producers then originated, with provisions giving the merged company responsibility on the non-compete agreements. National Securities owned about 36 percent of the surviving corporation (R. 718).

² Certainly much loss record information was given the shareholders; see App. 34, 64.

under generally accepted accounting practices" (Answer, para. 27, App. 105).

4. The SEC alleges that the literature mailed did not disclose that certain shares of Producers had been written down on the books of National Life to a given figure (Amended Complaint, para. 33(b), App. 95-96). The answer claims that the usage was proper (Answer, para. 33, App. 106).

B. Proceedings Through Ex Parte Order.

The purchase of the Producers Life shares occurred on April 27, 1964. On November 27, 1964, the Board of Directors of National Life and Producers agreed to merge (App. 18). Producers shareholders were soon to vote on the proposed merger, when on May 30 the Commission filed its complaint for an injunction (App. 11) and its application for a temporary restraining order, which was granted *ex parte* (App. 55).

The restraining order contained a paragraph of boiler plate—the defendants were enjoined from using interstate commerce or the mails "to engage in any manipulative or deceptive device or contrivance." There then followed four specific prohibitions, the practical effect of which restrained defendants from going forward with the merger (App. 56-58), voting any proxies which had been obtained for the merger, or "performing any act which facilitates or is designed to facilitate the consummation of" the merger (App. 57-58).

In short, the operative portions of the order enjoined the merger and any steps leading to it.

C. Proceedings from Application for Preliminary Injunction Through Merger.

The National Securities group of defendants answered, denying jurisdiction in the court, alleging that the complaint failed to state a claim upon which relief could be granted, and generally pleading to the complaint (App. 65). The Commission applied for a preliminary injunction (App. 25), and the defendants moved for judgment of dismissal and also for denial of the preliminary injunction (App. 4).

The matter came on for hearing on April 16, 1965 (Mathes, J.), the court concluding (App. 72-75) that the question of merger or no merger was essentially one for the State to decide. As had been fully developed before the court, any merger, if approved by the shareholders, must be presented to the State Insurance Department. The parties therefore stipulated in open court that if the meeting were held, and if the stockholders approved the merger, the SEC would be given a week's notice before the matter was submitted to the Insurance Director so that the Commission might take any action it desired.

As the court put it to the company, "You can hold your meeting, you can vote your proxies, you can submit it to the Insurance Commissioner or Director of Insurance." Undersigned counsel assured the SEC that it would have a week's telegraphic notice before submission, a time period accepted as "entirely satisfactory" to the Commission (App. 74). The Judge did not pass in any way on the validity of the proxies or the procedures in connection with the merger, simply leaving the whole matter to the Insurance Director (App. 75). On this basis, the court struck from the restraining order all except the boiler plate portion, eliminating every restraint upon the merger (App. 77-78).

There thus being no legal impediment, the shareholders overwhelmingly approved the merger (R. 437-38). The Commission was duly advised. It did not move for any stay of the cancellation of the operative portions of the temporary restraining order, nor did it apply to any higher court for relief. Instead, on April 28, the Commission wrote the Arizona Director of Insurance stating its view of the illegality of the proxy solicitation and forwarding to the Arizona Director all of the pleadings and evidentiary materials which had been before the Federal District Court (R. 390-97).

Under Arizona law, as will be more fully particularized, a merger of insurance companies can occur only upon approval by the Arizona Director of Insurance, who is expressly required to

consider stockholder as well as policyholder interests. Having had the opportunity to consider any matters which might have been presented by any objecting persons, and to consider the full record which was submitted by the SEC, the Arizona Director of Insurance approved the merger (R. 800), and the surviving insurance company has since functioned as National Producers Life Insurance Company (National Producers).³

D. Proceedings from Merger Through the District Court Ruling.

In August, 1965, a month after the merger (App. 8), the Commission filed its amended and supplemental complaint for injunction. The essence of the prayer for relief (App. 98-100) was that the parties should be required to undo the merger, restoring the companies and their stockholders to their pre-merger condition. The defendants responded with an answer (App. 101) and with a motion for judgment on the pleadings or in the alternative for summary judgment (App. 109).

On February 7, 1966, the trial court granted the motion for judgment on the pleadings (App. 139). The order of the district court noted and decided these points:

1. The charge was illegal solicitation of proxies in connection with a merger (para. 2, App. 140). To this end, the court in effect was asked to undo the merger.

2. The case was brought under § 10(b) of the Securities Exchange Act of 1934, and its concomitant Rule 10b-5. The acts complained of would fall within the prohibitions of the proxy-solicitation provisions and the antifraud provisions of a different section of that Act, § 14, but for two circumstances: first, § 14 did not, at the time of the transaction, apply to the company; its broadened coverage was not effective until 1966. Second, even in 1966, the section would apply only if insurance companies

³ As of 1968, there have been some ownership and structural changes which are outside the record. We therefore note merely that the statements relating to the insurance company and its parent are accurate as of the date of the closing of the record.

were not exempt under still another section which conditionally excluded insurance company securities (paras. 4-5-6, App. 141).

3. There were two subsidiary issues: first, a question as to whether § 10(b) applied to proxy solicitations at all; and second, a separate issue as to whether a statutory merger is a "purchase or sale" of securities within the meaning of § 10(b) of the Act. The district court expressed doubt as to coverage on both grounds, but did not rest its decision on either (para. 7, App. 141).

4. The district court thus came to its main ground of decision. It noted that under the McCarran Act, no Act of Congress should be construed "to invalidate, impair, or supersede any law enacted by any state for the purpose of regulating the business of insurance." It found that the law of Arizona did expressly provide that authority over insurance company mergers was given to the Director of Insurance who was required to consider, among other things, whether the plan was legal, fair to stockholders, or injurious to policyholders, and that under Arizona law there was adequate procedure for appeal from any decision of the Director on the merger issue (paras. 9, 10, 11, App. 142-43). It concluded that to invalidate the merger which had been approved by the Arizona Director of Insurance "would at least 'impair,' if not 'invalidate' or 'supersede,' laws enacted by the State of Arizona" for the regulation of insurance (para. 12, App. 143).⁴

E. Proceedings in the Court of Appeals.

The Court of Appeals affirmed (App. 148-61). It too treated the case as an effort by the Commission "to undo the merger of two stock life insurance companies" because of the proxy solicitation. The Court put aside as unnecessary for decision the question of whether there was an absence of indispensable parties; the

⁴ The district court also found (para. 13, App. 143-44) that nullification of the merger was beyond the court's power under this section of the Act, a decision appealed by the SEC but not decided by the Court of Appeals.

question of whether there was a "purchase or sale"; and the question of whether the statute permitted the relief requested (App. 154). It noted that Arizona had "accepted the invitation of the McCarran Act" (App. 157) to make its own regulation of insurance and that it had "affirmatively asserted its power to regulate the merger of insurance companies." (App. 159) It held that the effort by the SEC to invalidate the merger conflicted with the McCarran Act.

This petition duly followed.

Summary Of Argument

The parties see this case very differently. For the Commission, the issue is whether the McCarran Act immunizes transactions in securities of insurance companies from the application of the federal securities laws. But the company, which without any question submits to Commission jurisdiction in many securities matters, has never put this question in issue. Neither the District Court nor the Court of Appeals ever decided anything of the sort.

The McCarran Act question which does come here from the Court of Appeals is whether § 10(b) of the Securities Exchange Act of 1934 permits nullification of an insurance company merger for false and misleading proxy solicitations when the State Insurance Department under a State statute governing mergers has approved the merger after consideration of the identical materials which the SEC tendered both to it and to the District Court.

There are preliminary questions. Section 10(b) applies only to a "purchase or sale" of a security. In connection with a statutory merger, there is not in the obvious sense at least, any purchase or any sale; there is simply a conversion of stock. There is a direct conflict of Circuits on the point; see *National Supply Co. v. Leland Stanford Junior Univ.*, 134 F. 2d 689 (9th Cir. 1943), *cert. denied*, 320 U.S. 773, 64 S. Ct. 77, 88 L. Ed. 462 (1943), and *Dasbo v. Susquehanna Corp.*, 380 F.2d 262 (7th Cir. 1967), *cert. denied*, 389 U.S. 977, 88 S. Ct. 480, 19 L. Ed. 2d 470 (1967). The Commission itself has been on both sides of the

question, Justices Douglas and Fortas in their Commission days being connected with the position that there was "no sale" in these circumstances and the Commission now saying the opposite. We contend that there is no sale and rely heavily on the argument put forth by the Commission itself in the *National Supply Co.* case. The Commission squarely and specifically presented to Congress the question of whether this rule should be changed, and Congress has never seen fit to do so. If the rule is, however, now to be changed without benefit of the Act of Congress which the Commission once thought necessary, then we ask that the interpretation be prospective only; see *James v. United States*, 366 U.S. 213, 81 S. Ct. 1052, 6 L. Ed. 2d 246 (1961) and *Linkletter v. Walker*, 381 U.S. 618, 85 S. Ct. 1731, 14 L. Ed. 2d 601 (1965).

The McCarran Act does preclude the SEC's attack upon the merger of two Arizona insurance companies. The statute provides that no Act of Congress may "invalidate, impair, or supersede" a state law regulating the business of insurance. Here, directly on point in the heart of the Arizona Insurance Code, is a direct regulation of mergers, direct control of allegedly misleading statements, direct provision for the protection of investors as well as policyholders; see A.R.S. § 20-731 and other sections. We are hard put to imagine how the federal government could more totally impair or supersede a state regulation than to make a direct reversal of the State Insurance Department.

While the Commission seeks to construe the McCarran Act more narrowly than we believe does this Court, *SEC v. Variable Annuity Life Ins. Co.*, 359 U.S. 65, 79 S. Ct. 618, 3 L. Ed. 2d 540 (1959), even the SEC acknowledges that such historical matters as "the chartering and licensing of insurance companies" are within state power. The approval of this merger by the Insurance Department is merely a functional variant of chartering and licensing; by his approval, the Insurance Director permits the company to exist in its merged form. In repeated instances, Congress

has been assured that insurance mergers were state business unless the McCarran Act should be amended, as it has not been. Such decisions as *SEC v. Variable Annuity Life Ins. Co.*, *supra* and *SEC v. United Benefit Life Ins. Co.*, 387 U.S. 202, 87 S. Ct. 1557, 18 L. Ed. 673 (1967), on which the Commission relies, deal with activities by insurance companies which are not insurance at all, and where the companies are not "primarily engaged in the insurance business," SEC Br., *Variable Annuity*, *supra*, 55. In this instance, the issue is whether an insurance company shall be allowed to exist, and the company has no other activities of any kind except the most classic insurance business.

The fundamental question in this case is which court and administrative system in the United States has jurisdiction to decide whether these companies may merge. By virtue of the McCarran Act plus the complete and responsible assumption of power by the State, this is a State question.

Proxy solicitations for a merger are in any case not covered by § 10(b) of the Securities Act of 1934. Jurisdiction for this purpose was extended to the SEC only by virtue of an amendment to the law which did not take effect until after the events here involved, an amendment which was presented by the SEC to Congress on the express ground, among others, that it was needed in connection with proxy solicitations for mergers. We ask the Commission to tell us why the Commission told Congress that it needed to amend the Act to make the proxy rules applicable to mergers of over-the-counter companies without telling Congress, as it now contends, that it already had that power under an existing section of the 1934 Act.

Argument

I. Introduction.

This is one of those cases which is settled once the Court decides what it is about; the real battle is over definition of the issue. The Government states the question as whether the McCarran Act "precludes the application of the antifraud provisions of the

Securities Exchange Act of 1934 to false and misleading statements made in soliciting stockholder consents to a merger of insurance companies"; but its argument moves far indeed from this statement. The Summary of Argument at pages 8-10 does not even mention the word merger or consolidation or anything else relating to that subject matter. Rather, it confines itself to an argument aimed at "the applicability of the federal securities laws to transactions in insurance company securities." The essential argument of the Government, which occupies substantially all of its brief (pp. 10-28), is that "The McCarran-Ferguson Act does not immunize transactions in securities of insurance companies from the application of the federal securities laws." (SEC Br. 10)

The Government battles a straw man. No one contends that there is some general immunization of all securities of insurance companies from SEC regulation. Indeed, the very companies here principally involved, National Life and Producers, have filed registration statements or related documents with the SEC; see SEC Br., p. 16, n. 12. We have no doubt whatsoever that at least some SEC regulations apply to at least some insurance company securities in at least some states—doubtless many regulations apply in all of them.

It does serious injustice to the earnest efforts of the lower courts for the Government to present this case as if those courts had held that the Act does immunize transactions in securities of insurance companies from the application of federal securities laws. The district court found doubtful whether § 10(b) of the Securities Act of 1934 applies at all to proxy solicitations, but this gives no immunity, since a subsequent amendment now applies. The district court held that the State of Arizona has an express code regulating the merger of insurance companies which is broad enough to permit the Director of Insurance to consider, from every angle, all of the abuses which the Commission alleges occurred, and that there is adequate opportunity for judicial review in the State system. It thereupon found that to set aside the merger

would impair laws enacted by the State of Arizona for the purpose of regulating the business of insurance. In the four pages of findings by the District Court (App. 139-44), there is not a syllable open to the construction that insurance company securities generally are beyond the reach of the Commission.

The Court of Appeals with care stated what it regarded to be the only issue which it was deciding: "Whether the allegations of the amended and supplemental complaint, which allegations must be presumed by us to be true, warrant the invalidation of the merger in light of the provisions of the McCarran Act." The Court then sketched the background of the McCarran Act and noted that it contained an invitation to the states to deal affirmatively and effectively with insurance industry problems. The Court noted that "the State of Arizona accepted the invitation of the McCarran Act." And how did the State of Arizona accept this invitation? By certain specific statutes relating to trade practices; and the State also has (whether in response to the "invitation" or not) detailed regulations of mergers. Hence, the Court found that "the State of Arizona has affirmatively asserted its power to regulate the merger of insurance companies."

We believe that we have accurately stated the question presented: Does § 10(b) of the Act and its concomitant rule, read in the light of the McCarran-Ferguson Act, apply to allegedly false and misleading statements made in soliciting stockholder consents to a merger of insurance companies where the same matters, under applicable state statutes, have been before the Arizona State Director of Insurance who has approved the merger?

II. *A Merger does not Involve a "Purchase" or "Sale" of Securities.*

A. *This is a "No-Sale" Case.*

This action was originally brought under § 10(b) of the Securities Act of 1934. This section prohibits certain conduct "in connection with the purchase or sale of any security." If, therefore, a statutory merger is not a "purchase or sale," then we never reach the other questions of the case.

There is a direct conflict of Circuits on this point. The Seventh Circuit has held that a merger is a purchase or sale, *Dasbo v. Susquehanna Corp.*, 380 F.2d 262 (7th Cir. 1967), *cert. denied*, 389 U.S. 977, 88 S. Ct. 480, 19 L. Ed.2d 470 (1967). As the SEC acknowledges at p. 11, n. 6 of its brief, the Ninth Circuit stated the contrary in *National Supply Co. v. Leland Stanford Junior Univ.*, 134 F.2d 689 (9th Cir. 1943), *cert. denied*, 320 U.S. 773, 64 S. Ct. 77, 88 L. Ed. 462 (1943).⁵ As the instant case came to the Ninth Circuit, this was the big question in it; the Commission asked for an extension of time to brief the matter on the ground of the importance of the case because it wanted the Ninth Circuit to "overrule or severely delimit a determination previously made by it" in the *National Supply Co.* case.⁶

The Commission says in its brief here, "For many years the Commission has regarded an exchange of securities" as a "purchase" or a "sale" within the scope of this Act; SEC Br., p. 11. But it was not ever so. When Mr. Justice Douglas was chairman of the Commission and Mr. Justice Fortas was a member of its staff, the Commission took the opposite view. The Ninth Circuit *National Supply Co.* opinion was based on the then stand of the Commission that a consolidation did not involve a sale, and this in turn was based upon a report transmitted over the signature of Mr. Justice Douglas, based on staff work by, among others, the present Justice Fortas; for details, see the Report, the relevant portions of which we have placed in Appendix B to

⁵ The Government also claims in the same note that the Second Circuit has agreed with the Seventh in *Vine v. Beneficial Finance Co.*, 374 F.2d 627 (2d Cir. 1967), *cert. denied*, 389 U.S. 970, 88 S. Ct. 463, 19 L. Ed. 2d 460 (1967). The *Vine* case, which involved a compulsory exchange of stock for money, we think distinguishable, as it expressly asserts itself to be: "It is precisely because appellee gives no choice to Vine under the statute and the latter must now exchange his shares for cash that appellee can now be deemed a seller." 374 F.2d at 635.

⁶ See affidavit of Newman in support of motion of the Commission for enlargement of time, Dec. 29, 1966.

this brief.⁷ The earlier Commission report stated that in the case of a "typical consolidation, merger, or sale of assets," the essential element of a sale was absent.

We of course savor the fact that then, at least, such high authority seems to have shared our view of the matter; for we do contend that a merger is not a sale at all. We are dealing with what is called the "no-sale doctrine" and the interpretation of the 1934 Act in this respect begins with the 1933 Act. Section 17 of the 1933 Act, 15 U.S.C. § 77g, in various ways is directed at frauds in the sale of securities. The term "sale" is used also in Section 5 of the 1933 Act, 15 U.S.C. § 77f, and in turn is defined in Commission Rule 133, 17 C.F.R. 230.133. It is thus Rule 133 and its antecedents which is the origin of the "no sale doctrine."

Rule 133 expressly excludes from the definition of "sale" a transaction (a) where, in accordance with state law, a plan or agreement for a statutory merger or consolidation is submitted to the vote of the stockholders; (b) where such a merger can be adopted only upon the vote of some established majority of the outstanding stock; and (c) where such a vote is binding on all stockholders except to the extent that dissenters may be entitled to receive the appraised or fair value of their holdings. Rule 133 could not cover more precisely an Arizona statutory merger—every item in the rule is also in the Code.

It follows that if the no-sale doctrine embodied in Rule 133 as applied to the 1933 Act is equally applicable to § 10 of the 1934 Act, then there could not conceivably be jurisdiction in the instant case because there is no "sale."

We begin with precisely what it was that the parties were

⁷ This was a large work, and we do not mean to suggest that we can tell from the Report whether either of the Justices was individually, as distinguished from institutionally, responsible for this detail. As noted above, the relevant language is in the Appendix. See SEC, Report on the Study and Investigation of the Work, Activities, Personnel, and Functions of Protective and Reorganization Committees, pt. VII, p. 249, n. 172 (1938).

doing. The consolidation or merger plan presented for the vote for which proxies were solicited (App. 41-42) provided that "The principal purpose of this Agreement is to provide for the merger of National Life into Producers, which will continue as the surviving corporation, governed by the laws of the State of Arizona." The parties agreed to submit their plan to the Director of Insurance and to the stockholders (R. 80).

For the actual stock conversion, Paragraph 12 of the Agreement covers the "manner of converting the shares and assets of National Life." Producers was to "issue and deliver to the stockholders of National Life" a share of Producers stock for each share of National Life stock. If a National Life stockholder for whatever reason simply kept his National Life stock, the same paragraph provided that he should be regarded "for all corporate and legal purposes, to be the owner of that number of National Producers shares." (App. 45.)

That is it. Prior to the merger, each shareholder had a certain number of shares of stock of Producers and after it, he had the equivalent in shares of National Producers. Before the merger, each shareholder of National Life had National Life shares, and after the merger, he had the same number of National Producers Life shares, with a minor adjustment to avoid fractions, Para. 16 of the Consolidation Agreement (R. 79 at 82).

The plan and the actuality were closely guided by the Arizona Code. A.R.S. § 10-341-49 covers mergers. Two corporations "may be consolidated"; they do so by making an agreement which covers how to convert the shares and assets of the retiring corporation. Notices are required and then "the agreement of the Boards of Directors to consolidate" is submitted to the shareholders. The vote, for which solicitation of proxies is expressly authorized, A.R.S. § 10-344, is whether to adopt or reject the consolidation plan. A non-insurance merger is legally effective upon the ratification of the agreement by each of the corporations, and there is no requirement that the shares even

be turned in or replaced. Dissenting stockholders may elect to be paid in cash for their shares. The Insurance Code adds to these requirements the approval by the Director of Insurance.

The transaction is a straight conversion, with no purchase or sale about it. A consolidation agreement either is or is not approved by the shareholders. If it is approved, then the National Life shareholders may, if they wish, turn in their old certificates and get new certificates, but no one buys, no one sells. If they do not wish to turn the old certificates in, they need not do so—the operative legal effect is all the same by virtue of simple conversion occurring from the act of approval of the agreement itself. The shareholder has the option, if he wishes, of getting a new certificate to represent the stock he actually holds. Any shareholder at any given point has two separable interests, the one his actual interest or ownership of his fraction of the corporation, and the other his piece of paper which is evidence of that ownership. The shareholder's actual interest is changed by the vote on the consolidation agreement and the resultant filings and approvals, and this without the faintest semblance of anyone selling or purchasing anything. All that happens thereafter is the exchange of pieces of paper recognizing this interest.

In the *National Supply Co.* case in the Ninth Circuit, the SEC filed a brief which was deposited with the District Court Clerk in the instant case. It contained the following language:

"But consolidations such as the one involved in this case and mergers under related provisions of law are not comparable to the various exchange situations just discussed. In such consolidations and mergers the alteration of the stockholder's security occurs not because he consents to an exchange, but because the corporation by authorized corporate action converts his security from one form to another. That is to say (as indicated by the Note to Rule 5), there is no sale where (1) the vote of the stockholders is effective (subject to directors' action and other statutory requirements) as corporate action and (2) this action binds all stockholders, assenters, dissenters, and non-voters alike (subject only to appraisal

rights of dissenters). The essence of the Commission's construction, as expressed in the Note, is that in such cases a proposed corporate act is submitted to stockholders to be accepted or rejected by them as a class, in their capacity as members of the corporate body. . . .

"A few examples will illustrate the difference between submission of a proposal for corporate action and an offer of exchange to stockholders as individuals:

"(1) A proposal for merger or consolidation is submitted to the vote of the directors of a corporation before being submitted to the stockholders. Although the merger or consolidation, if consummated, will result in the directors getting different securities for those they held before the vote, we think it obvious that the submission of the proposal to them is not a sale, because they act in their capacities as functionaries of the corporation, not as security holders. The fact that they may hold securities which will be changed by the corporate action is immaterial, since the submission to them is not for the purpose of choice as individuals but as a step in the process of corporate action. We believe that subsequent submission of the same plan to those same directors as stockholders no more involves a sale than does the submission to them as directors. Both directors' vote and stockholders' vote are necessary parts of the process of corporate action."

For reasons so well set forth by the SEC in the earlier case, we respectfully submit that there is no sale here on which § 10(b) can operate. Moreover, the SEC told Congress the same thing, and directly put up to Congress the question of whether to amend the Act. In 1941, in hearings on proposed changes in the Acts of 1933 and 1934, SEC Commissioner Purcell expressly directed the attention of the committee to "item 9 of the agenda, concerning the issue of securities in mergers, consolidations, and reorganizations."

Commissioner Purcell thereupon presented a comprehensive analytical statement with direct reference to the *National Supply* case which was then pending. He said:

"The Commission has reached the conclusion that the act was not intended to apply where (1) the vote of the stock-

holders is effective (subject to directors' action and other statutory requirements) as corporate action, and (2) this action binds all stockholders, assenters, dissenters, and nonvoters alike, subject only to appraisal rights of dissenters.⁸

This is precisely the instant situation. On the other hand, the Commissioner said, just as the SEC says today, that there is a possibility of some injury to the general public from inadequate control of mergers. Since "The Commission has interpreted the act as not applying," he said, and since the matter was pending in *National Supply*, "this committee may well wish to consider this problem, since if the interpretation is upheld Congress may desire to amend the act in order to bring these transactions within its registration provision."⁹

Congress has never seen fit to adopt the implied suggestion of the Commission that the Act be amended to apply to a situation such as the present. We cannot share the view that the Commission misinformed the Ninth Circuit Court of Appeals in 1943 and the Congress in 1941. We think that until Congress changes the statute, the Commission does lack the power it said it lacked. We appreciate that advocacy of legislation by an agency may be an unreliable guide as to the existing state of its powers, *American Trucking Ass'n v. Atchison, T. & S.N. Ry. Co.*, 387 U.S. 397,

⁸ In *Dasbo*, *supra*, the Seventh Circuit in coming to a different result, says (380 F.2d at 269): "This view does no violence to the statutory language, and is the present interpretation of the body which is responsible for the administration of the acts." This is true, but if we may respectfully say so, irrelevant. The law, particularly of commercial transactions, cannot change every time the SEC switches to a new and plausible alternative. The object of interpretation is to achieve the intent of the legislature, *Vermilya-Brown Co. v. Connell*, 335 U.S. 377, 69 S. Ct. 140, 93 L. Ed. 76 (1948), and countless other cases. This is a goal often difficult or obscure and sometimes nonexistent; but the mere fact that a given construction is plausible and that the SEC now sees the matter differently than it did earlier is not even constructive evidence of 1934 intent.

⁹ Hearings on H.R. 4344, H.R. 5065, and H.R. 5832 Before the House Committee on Interstate and Foreign Commerce, 77th Cong., 1st Sess., pt. III, at 842, 845 (1941). The Investment Bankers Association, the National Association of Security Dealers, the New York Curb Exchange, the New York Stock Exchange, and the National Association of Manufacturers, in a joint statement, *id.* at 846-50, opposed extending the Act to mergers.

418, 87 S. Ct. 1608, 18 L. Ed. 2d 847 (1967), and that interpretation may not be foreclosed because of subsequent views concerning its scope, *United States v. Philadelphia Nat'l Bank*, 374 U.S. 321, 348-49, 83 S. Ct. 1715, 10 L. Ed. 2d 915 (1963); but at the same time, an unsuccessful effort to get broader authority from Congress is at least some indication that a power does not exist, *FTC v. Bunis Bros., Inc.*, 312 U.S. 349, 352, 61 S. Ct. 580, 85 L. Ed. 881 (1941). This is particularly persuasive where the effort is combined, as here, with early administrative interpretation by those charged with the application of an act when it is untried and new, *Power Reactor Dev. Co. v. International Union*, 367 U.S. 396, 81 S. Ct. 1529, 6 L. Ed. 2d 924 (1961), and administrative practice is of special weight where, as here, reliance is placed on it, *Sanford's Estate v. Commissioner*, 308 U.S. 39, 60 S. Ct. 51, 84 L. Ed. 20 (1939). There is a suggestive analogy in *Blau v. Lehman*, 368 U.S. 403, 82 S. Ct. 451, 7 L. Ed. 2d 403 (1962), which also involved interpretation of the Securities Exchange Act of 1934. Language which would result in the interpretation which the SEC desired in *Blau* had been presented to Congress and not adopted; there, too, Congress left in effect an outstanding Court of Appeals decision. There, too, for a long time, the Commission at least acquiesced in that result. There, too, the Court of Appeals had relied on a then outstanding Commission interpretation. There, too, the SEC had strong policy arguments for the interpretation which it later desired. In the circumstances, this Court said:

"Congress can and might amend § 16(b) if the Commission would present to it the policy arguments it has presented to us, but we think that Congress is the proper agency to change an interpretation of the Act unbroken since its passage, if the change is to be made." 368 U.S. at 413.

B. If the "No-Sale" Rule is to be Changed, it should be Prospective Only.

In 1964, Producers had a practical decision to make. Should it guide its proxy materials by detailed and precise SEC standards,

or should it rely on the existing Ninth Circuit decision in *National Supply*, based on the SEC brief, that the merger was not a sale? If so, it would move through the state channels and rely on its conception of state standards.

We submit that it would be the most severe and unwarranted injustice to apply a reinterpretation of the no sale rule retroactively to this transaction. We are talking about undoing a merger, now well established, of two considerable insurance companies. There is no suggestion of any significant injustice to anyone in the Government's brief, and there is obvious injustice to all subsequent investors in unsettling the transaction. The Government did not ask for a stay or reinterpretation of the *National Supply* rule before the merger, when there was abundant opportunity to have gone to the Circuit, 28 U.S.C. § 1292(a)(1) and Fed. R. Civ. P. 62(c).

This Court has repeatedly made new interpretations prospective; see *Gelpcke v. Dubuque*, 68 U.S. 175, 17 L. Ed. 520 (1864). The Court has recently applied the principle of fair reliance in the criminal field, *Johnson v. New Jersey*, 384 U.S. 719, 86 S. Ct. 1772, 16 L. Ed. 2d 882 (1966); and Professor Moore stresses the equal applicability of the principle in civil cases:

"Where title to land or commercial transactions are involved, demanding stability because of general reliance upon past precedent, the overruling decision should be given only prospective effect." 1B J. Moore, *Federal Practice* 203-04, and see also 209 (2d ed. 1965).

See also *England v. Board of Medical Examiners*, 375 U.S. 411, 422, 84 S. Ct. 461, 11 L. Ed. 2d 440 (1964), a direct holding that an interpretation would not be applied retroactively where a party had reasonably relied on a different understanding; and see also *Great N. Ry. v. Sunburst Oil & Ref. Co.*, 287 U.S. 358, 53 S. Ct. 145, 77 L. Ed. 360 (1932). This Court has stressed the importance of avoiding applications of law resulting in "prejudice" to "those who might have relied on" earlier understanding, *James v. United States*, 366 U.S. 213, 221, 81 S. Ct. 1052, 6 L. Ed. 2d

246 (1961), and has said that the same principles apply in civil and criminal litigation in this regard, *Linkletter v. Walker*, 381 U.S. 618, 85 S. Ct. 1731, 14 L. Ed. 2d 601 (1965). See generally and helpfully, Note, *Prospective Overruling and Retroactive Application in the Federal Courts*, 71 Yale L. J. 907 (1962).

The Government, well aware of its position in *National Supply*, and as if to anticipate this suggestion, says at p. 11 of its brief:

"... and for many years the Commission has regarded an exchange of securities such as was involved in the consolidation of National Life and Producers Life as constituting a 'purchase' or 'sale' of securities under the antifraud provisions of the Securities Exchange Act of 1934 and the Securities Act of 1933."

The only cases cited by the Government, as it notes, are recent; they were decided after this merger occurred. The evidences cited of the Commission's "many years regard" are two releases, Nos. 3965 (1958) and 4115 (1959). The first is a proposed revision of Rule 133 which in its terms does not bear on this matter, but which does contain some language by way of "staff recommendation" hostile to the no sale rule. The second is simply the language of revised Rule 133 which contains nothing at all on this point. Intriguingly, the Commission had what was from its point of view a better release, No. 3420, which really is hostile to the no-sale rule, dated August 2, 1951. Symbolic of the unsoundness of this kind of law-making by release is the fact that we discovered No. 3420 in the course of research for this brief, and the Commission, for whatever reason, has not as yet cited it in this case at all.

This, we must respectfully submit, is lawmaking by rumination. Surely practical men of affairs cannot be seriously expected to govern themselves by SEC "staff recommendations" which never result in a regulation on point. The SEC presented its no sale policy by a formal report endorsed by the Chairman of the Commission. It made that policy concrete and saw it into the law by a brief directed to the proposition in the Ninth Circuit. It expressly

and in precise terms took the problem to Congress, acknowledging its lack of jurisdiction and suggesting that Congress make a change if one was desired. It is simply too much to ask the business community to know that all this is reversed because the unidentified anonymities who make up "staff" are dissatisfied, particularly when they never persuaded the Commission to adopt their dissatisfaction in any express rule. To borrow the biting language of Justice Cardozo, dissenting on other matters only, in *Panama Ref. Co. v. Ryan*, 293 U.S. 388, 434, 55 S. Ct. 241, 79 L. Ed. 446 (1935), this is "a non-existent mandate," and assuming *arguendo* that the Commission's new policy now has status, "One must deplore the administrative methods that brought about uncertainty for a time as to the terms of executive orders intended to be law."

III. *The McCarran Act does Preclude the SEC's Attack upon this Merger of Two Arizona Insurance Companies.*

A. *Introduction.*

Section 2(b) of the McCarran Act provides that "No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance," with exceptions not material here. Acting under a state statute which deals expressly and precisely with mergers of insurance companies, the Arizona Director of Insurance has said that a given insurance company, National Producers Life, may exist. The SEC asks for a court order that it may not exist. One would be hard put to contrive any method of more totally impairing or superseding the state law than this.

But, says the Commission, the McCarran Act preserves to the states only those matters of insurance regulation which historically the states have managed. *Maryland Cas. Co. v. Cushing*, 347 U.S. 409, 74 S. Ct. 608, 98 L. Ed. 806 (1954), dissenting opinion, (Black, J.) puts it succinctly: "The Act rather shows the strong purpose of Congress to permit states to continue regulating insurance as they always had." What, according to the SEC, are

the subjects of these regulations? "Historically, such matters as the chartering and licensing of insurance companies; the insurance rates; the content, form and issuance of insurance policies. . ." (SEC Br. 17). For all functional purposes, that is precisely what is here involved—by approving the merger of National Life into Producers, the Director was permitting National Producers Life to do business just as if it were being licensed. When the McCarran Act was passed in 1945, superintendence and control of mergers was a standard function of many insurance departments.¹⁰ Many of these focused on policyholder interests, but Arizona's Act, adopted in 1954 after the McCarran Act, expressly reaches shareholder interests as well.¹¹

Insurance mergers have been commonly considered beyond federal control when the states had overlapping regulations. The Senate Judiciary Committee, Subcommittee on Antitrust and Monopoly, held extensive hearings on the insurance industry in the 86th Congress, First Session. In a letter to Senator Joseph C. O'Mahoney, Victor R. Hanson, then Assistant Attorney General, Antitrust Division, said:

¹⁰ In 1945 at least fifteen states regulating insurance company mergers by insurance code (as distinct from corporate code) provisions were:

ARKANSAS, Pope's Ark. Stat. § 7682 (1937);
 ILLINOIS, 73 Smith-Hurd Ill. Ann. Stat. §§ 768-82 (1961);
 KANSAS, Kans. Stat. Ann., ch. 40, § 309 (1964);
 MAINE, Me. Rev. Stat., ch. 56, § 4 (1944);
 MASSACHUSETTS, Mass. Gen. Laws Ann., ch. 175, §§ 19A-C (1958);
 MICHIGAN, 3 Mich. Com. Laws § 511.20 (1948);
 MINNESOTA, Minn. Stat. §§ 60.55-57 (1945);
 MISSOURI, Mo. Rev. Stat. § 6052 (1939);
 NEW YORK, 27 McKinney's Laws of N. Y. Ann. §§ 480-504 (1966);
 NORTH CAROLINA, N. C. Code § 217(n) (1935);
 NORTH DAKOTA, N. D. Code Ann. § 26-20-01 to -08 (1960);
 OKLAHOMA, Okla. Stat. tit. 36, §§ 81-91 (1951);
 PENNSYLVANIA, Purdon's Pa. Stat. Ann., tit. 40, §§ 455-459a (1954);
 TEXAS, Vernon's Tex. Stat., art. 5040, 41 (1936); and
 WISCONSIN, Wis. Stat. § 206.38 (1945).

¹¹ In addition, A.R.S. § 20-615(4) authorizes the Director of Insurance to put a company into receivership if it merges "without having first obtained the written approval of the director."

"However, the *National Casualty* case does indicate that the limits which the McCarran Act imposes upon our jurisdiction to deal with insurance company activities which are subject to state regulation, exist without regard to how effective such regulation may be. For example, we recently considered a proposed merger (which had been reported in the press) between a large property insurance company and a life insurance company. Since the pertinent state insurance statutes contain a so-called Little Clayton Act, we concluded that the Clayton Act was not applicable to the merger."¹²

Referring to the instance described in the letter quoted above:

"Mr. McHugh. I understand you told us, Mr. Bicks, you concluded as a result of this study that the mergers did have anti-competitive implications which may be injurious to the public, and nevertheless the Department of Justice concluded it was powerless to act under the Clayton Act because of the presence of state laws in this area.

"Mr. Bicks.¹³ That is true." Insurance Hearings, *supra*, at 933.

See also the Statement of Federal Trade Commission Chairman John Gwynne:

Mr. McHugh. " . . . Judge Gwynne, do you construe the *American Hospital* and *National Casualty* cases as ousting the Federal Trade Commission from jurisdiction where the states have their own 'little antitrust acts' which do not by their terms apply to insurance?"

Mr. Gwynne. "I think the whole intent of the McCarran Act was to give the control of the insurance to the states, insofar as it could be done.

"I have always felt that if a state adopts a law that covers the field and constitutionally may cover the field that the federal government is not required to examine as to how they are enforcing it unless, as the Supreme Court says, it is a mere pretense.

¹² Hearings on the Insurance Industry Before the Subcomm. on Antitrust and Monopoly of the Senate Comm. on the Judiciary, 86th Cong., 1st Sess., pt. 2, at 931.

¹³ Assistant Attorney General, Antitrust Division. The Mr. McHugh is Donald P. McHugh, subcommittee counsel, who concluded that the federal government should be authorized to enter the merger field; Maloney, *Federal Regulation of Insurance*, 1960 *Ins. L. J.*, at 363, 369.

"I think that, to answer your question directly I think any statute which in effect practically regulates the activities which the Commission also has authority to regulate would oust the Commission of jurisdiction." *Id.* at 953-54.

It may be that Congress will conclude that state regulation of insurance mergers is inadequate; it has squarely faced the problem, but has so far declined to act. See Senate Comm. on Judiciary, Insurance: Aviation, Ocean Marine, and State Regulation, S. Rep. No. 1834, 86th Cong., 2d Sess. (1960), which is very critical of state insurance merger regulation, and particularly p. 216. But the Committee's point is that if change is needed, the McCarran Act must be amended:

"Stern necessity may require that the federal government assume a more enforceable role in insurance mergers. The Anti-trust Division of the Department of Justice continues to assert that one of its foremost if not principal responsibilities is to check in its incipency the substantial lessening of competition resulting from mergers and acquisitions. It is evident that State insurance departments have devoted little time to these considerations. In many cases they are not technically equipped to handle the problem. Serious questions exist as to their power under state law to cope with the myriad complexities of large mergers. Against this background, the responsibility of the Federal Government looms large in achieving uniformity of policy, filling the vacuum resulting from defects in State authority, and protecting our competitive economy from the inroads of concentration. *This is clearly an area where amendments to the McCarran Act may be needed.* To date, the anti-trust enforcement agencies have not seen fit to request additional authority in the insurance field. Developments in the industry in the immediate future and the experience of the Federal Government under the present law will determine the ultimate need for any change." *Id.* at 226 (emphasis added).

B. The McCarran Act Bars Federal Supersession of State Insurance Laws:

The spirit of the McCarran Act is recognized in the majority opinion in *SEC v. Variable Annuity Life Ins. Co.*, 359 U.S. 65, 79 S. Ct. 618, 3 L. Ed. 2d 640 (1959), in which Justice Douglas for the Court said:

"We start with a reluctance to disturb the state regulatory schemes that are in actual effect, either by displacing them or by superimposing federal requirements on transactions that are tailored to meet state requirements. When the States speak in the field of 'insurance,' they speak with authority of a long tradition. For the regulation of 'insurance,' though within the ambit of federal power, (*United States v. South-Eastern Underwriters Ass'n*, 322 U.S. 533, 64 S. Ct. 1162, 88 L. Ed. 1440), has traditionally been under the control of the States." 359 U.S. at 68-69.

The legislative history is developed in the dissenting opinion in that same case in language which we think a majority would equally accept, as follows:

"In 1944, this Court removed the supposed constitutional basis for exemption of insurance by holding, in *United States v. South-Eastern Underwriters Ass'n*, supra, that the business of insurance was subject to federal regulation under the commerce power. Congress was quick to respond. It forthwith enacted the McCarran Act, 59 Stat. 33, 15 U.S.C. §§ 1011-1015, 15 U.S.C.A. §§ 1011-1015, which on its face demonstrates the purpose 'broadly to give support to the existing and future state systems for regulating and taxing the business of insurance.' *Prudential Insurance Co. v. Benjamin*, supra, 328 U.S. at page 429, 66 S. Ct. at page 1155, and 'to assure that existing state power to regulate insurance would continue.' *Wilburn Board Co. v. Fireman's Fund Ins. Co.*, supra, 348 U.S. at page 319, 75 S. Ct. at page 373. Thus rather than encouraging Congress to enter the field of insurance, the South-Eastern decision spurred reiteration of its undeviating policy of abstention." 359 U.S. at 99.

The McCarran Act is comprehensive legislation. It is applicable "to federal statutes now in existence," and to "any federal statutes

which may be enacted in the future."¹⁴ The statute was enacted because Congress did not wish "to take upon itself the responsibility of interfering with the taxation of insurance or the regulation of insurance by the States."¹⁵ Whenever the state legislates "specifically . . . upon a particular point," the state legislation prevails even if it conflicts with an Act of Congress.¹⁶

The general principles of the McCarran Act have been repeatedly upheld and applied. "Unless a Federal statute is made specifically applicable to the insurance business, it shall not 'invalidate, impair or supersede' any State insurance law." *Allstate Ins. Co. v. Lanier*, 361 F.2d 870, 872-73 (4th Cir. 1966). The guiding principle is that "Where there is an applicable state statute, the federal legislation does not apply." *Transnational Ins. Co. v. Rosenlund*, 261 F. Supp. 12, 26 (D. Ore. 1966). See also *North Little Rock Transp. Co. v. Cas. Reciprocal Exch.*, 181 F.2d 174 (8th Cir. 1950) (state rating bureau upheld as against Sherman Act); *California League of Independent Ins. Producers v. Aetna Casualty*, 175 F. Supp. 857 (N.D. Cal. 1959) (similar).

We cannot share with the Commission its sense of the relevance of the holdings in *SEC v. Variable Annuity Life Ins. Co.*, 359 U.S. 65, 79 S. Ct. 618, 3 L. Ed. 2d 640 (1959), commonly referred to as *VALIC*, or *SEC v. United Benefit Life Ins. Co.*, 387 U.S. 202, 87 S. Ct. 1557, 18 L. Ed. 2d 673 (1967). These cases

¹⁴ Excerpt from discussion between Senators Murdock and Ferguson, 91 Cong. Rec. 479 (1945).

¹⁵ *Id.* at 481, Senator Ferguson.

See the observation of SEC Commissioner Sumner T. Pike before the Temporary National Economic Committee, making certain suggestions for the regulation of insurance. Commissioner Pike said:

"It should be made clear at this stage, however, that in offering the above suggestions, there is no desire on our part to increase the powers of the Securities and Exchange Commission. The Commission has already several acts to administer and the addition of insurance problems to its already complex duties would so overburden the staff and the Commissioners as to prevent the Commission from doing an adequate job in the fields to which it is already assigned." S. Doc. No. 35, 77th Cong., 1st Sess. 596 (1941).

¹⁶ *Id.* at 1481, Senator Ferguson.

involve the distinction between security investments and insurance; they dealt with the "basic difference between a contract which to some degree is insured and a contract of insurance," 387 U.S. at 211. The investment contracts were held not to be insurance and did not involve the "business of insurance." As the Commission said in its brief in *VALIC*:

"The basic reason why the McCarran-Ferguson Act has no effect on the federal security acts in this case is that the contracts here involved are not insurance and the respondents are not primarily engaged in the insurance business." Brief of Petitioner at 55, *SEC v. Variable Annuity Life Ins. Co.*, 359 U.S. 65, 79 S. Ct. 618, 3 L. Ed. 2d 640 (1959).

Moreover, whether the state really had any relevant regulation was in issue in both *VALIC* and *United Benefit*. The SEC in *VALIC* emphasized that the District of Columbia Insurance Code contained no prospectus requirements for the purchasers of variable annuities, no requirement for independent directors, no requirement for the adoption of fundamental investment policies, and nothing similar to other provisions of the Investment Company Act; see SEC Br. 9-11 in *VALIC*, *supra*. In the instant case, the Arizona Insurance Department has very direct responsibility for the interests which the SEC wishes to protect.

C. *The Arizona Insurance Code Contains Direct Provisions Which are Impaired or Superseded by the SEC Action.*

The SEC stresses that "The traditional thrust of state insurance regulation has been the protection of policyholders, not stockholders," citing to the concurring opinion of Mr. Justice Brennan in *VALIC*, *supra*, 359 U.S. at 78-79. Whatever the weight of this observation may be in other jurisdictions, the Arizona law categorically makes it the duty of the Director of Insurance, in passing upon a merger, to consider whether the consolidation would be

"inequitable to the stockholders of any domestic insurer involved."
A.R.S. § 20-731B.2.¹⁷

If states are to enjoy their McCarran Act privileges, they must have good faith legislation in the general area of the federal legislation.¹⁸ As Senators Barkley and McCarran developed in the discussion of the McCarran Act on the floor, it is not enough for the states simply to act "by going through the form of legislation."¹⁹ On the other hand, the state legislation does not have to be identical to the federal regulations; see *FTC v. National Cas. Co.*, 357 U.S. 560, 564, 78 S. Ct. 1260, 2 L. Ed. 2d 1540 (1958). Here, as there, "petitioner does not argue that the statutory provisions here under review were mere pretense."

We come then to the fundamental question of this case: Which administrative and court system of the United States is to have jurisdiction to decide whether these companies may merge? Will

¹⁷In Appendix B to our Opposition to the Petition for Certiorari in this case, we classified the 50 states on mergers, with full citations. Thirteen, including Arizona, have merger provisions specifically directed to the investor interest, and also have fraud control provisions; ten have either no or limited merger control provisions; and the remainder do not specifically refer to consideration of rights of stockholders. The "traditional" thrust to which the SBC refers harks back to the day when most life insurance companies were mutuals, and policyholder protection thus included stockholder protection. The increasing attention to stock problems of insurance companies by state regulatory legislation is a reflection of the shift in the nature of the industry from mutual to stock companies. Only 20 of the 1,500 stock companies now in existence were formed before the turn of the century. Prior to World War II, stock insurance companies were responsible for only 20% of the life insurance in force in this country, while today there are 1,551 stock insurance companies which carry 45% of the life insurance in existence in the United States. For current descriptive detail, see *Institute of Life Insurance, Life Insurance Fact Book* 98 (1967), and for historical background, see A. Milton, *Life Insurance Stocks: An Investment Appraisal*, 37-65 (1965).

¹⁸*Cf. United States v. Sylvanus*, 192 F.2d 97 (7th Cir. 1961), a mail fraud case in which the state insurance director had no criminal remedy as against an insurance company officer who engaged in fraudulent advertisements. The state regulation must also be effectively operative within the state's own borders, *FTC v. Travelers Health Ass'n*, 362 U.S. 293, 80 S. Ct. 717, 4 L. Ed. 2d 724 (1960).

¹⁹See Barkley-McCarran exchange, 91 Cong. Rec. 1444 (1945).

it be the SEC and the federal courts, or the state insurance department and the state courts? As Justice Curtis said in a familiar passage, "Let it be remembered, also—for just now we may be in some danger of forgetting it—that questions of jurisdiction were questions of power as between the United States and the several states."²⁰ Who has the power to decide this specific question?

This in turn leads to the *precise* questions which need to be decided. As the Government brings the case to this Court, the merger should be set aside because, in appealing to its shareholders for proxies to support the merger, Producers is alleged to have made four nondisclosures or misleading statements concerning material matters. All four of these are put in issue by the pleadings, and someone therefore must decide these things:

(a) Did National Securities in fact fail to disclose the obligations on the non-compete agreements? Should it have disclosed earlier losses, and did it? Did it erroneously include a given asset? And did it fail to disclose how the value of stock had been handled by National Life in the 1964 annual report?

(b) Assuming *arguendo* that one or more of these treatments of matters of fact was erroneous, is this of sufficient consequence to bar the merger?

These matters were before the Director of Insurance under directly applicable State law. The ultimate question is merger or no merger. A.R.S. § 20-731, set forth in the Appendix, expressly requires domestic stock insurers (which these were) to obtain the written approval of the Director of Insurance for any mergers. The Director is required to consider whether the merger will be "contrary to law"; or "inequitable to the stockholders of any domestic insurer involved"; or "would substantially reduce the security and service to be rendered to policyholders of the domestic insurer in this state or elsewhere." If the fundamental implications of the SEC's charges are well taken, then the merger would

²⁰ As quoted on the frontispiece of *F. Frankfurter & H. Shulman, Cases and Other Authorities on Federal Jurisdiction and Procedure* (rev. ed., Callaghan & Co., 1937).

be all of these things—it would be contrary to law, it would be inequitable to stockholders, and it would reduce the security of and service to be rendered to policyholders.

Misleading statements are "contrary to law" as an express violation of two Arizona statutes; see Appendix to this brief. The first is A.R.S. § 20-444A, which makes it illegal to distribute any statement relating to insurance which is "untrue, deceptive or misleading." The second is A.R.S. § 20-443(3), which makes it unlawful to make "any misleading representation or any misrepresentation as to the financial condition of any insurer." These provisions are part of Title 20, ch. II, art. 6 of the Arizona Code, which by its preface shows that it was expressly adopted for the purpose of complying with the McCarran Act and of taking up the responsibilities recognized by Congress in that statute.²¹

The fundamental flaw in the SEC position is its bland assumption that a state power does not exist if it is not exercised as the Commission would like to see it exercised. As proof that the state does not have adequate power in this field, the SEC says, Br. 12-13, that "Indeed, in this very case the State insurance commissioner, approved the merger under a statute which prohibits 'untrue, deceptive or misleading' statements 'with respect to the business of insurance,' even though the Commission had submitted to him 'all of the pleadings and evidentiary materials which had been before the Federal District Court' (Br. in Opp. 4), which alleged that seriously false and misleading information was being used in soliciting stockholders' consents to the merger."

²¹ The SEC suggests that Arizona's "Little McCarran Act" is somehow inapplicable because it is "directed toward unfair practices and frauds in the transaction of an insurance business." The Act is in fact carefully and scrupulously as broad as the McCarran Act, regulating "all" practices of the offending types "in the business of insurance." Sponsored by the National Association of Insurance Commissioners to meet McCarran Act standards, and called the All Industries Fair Trade Practices Act, the provisions have been adopted in a number of states. For a table enumerating thirteen states with laws similar to Arizona's, though not in all cases identical, with respect to fraud controls, see Appendix B to our Opposition to the Petition for Certiorari.

The assumption that the State must be powerless if it disagrees shows consummate self-satisfaction by the Commission with its own omniscience.

But the fact that the State Insurance Director evaluated these materials differently than would the SEC does not mean that he was powerless to make the judgment. He was free to conclude that the particular statements were either never made, or were not deceptive, or were inconsequential or that there was no false and misleading information. Under an elaborate state insurance code, he made that very decision; and to reverse him by federal court action is "to invalidate, impair, or supersede" the Arizona laws regulating the business of insurance.²² Let us leave the matter

²² The Ninth Circuit decision is thus read in *Hamilton Life Ins. Co. v. Republic Nat'l Life Ins. Co.*, 67 Civ. 4855, an extensive opinion by Judge Herlands in the Southern District of New York, July 30, 1968, as yet unreported. The case, dealing with the application of the McCarran Act to the Federal Arbitration Act, said:

"*SEC v. National Securities Inc.*, 337 F.2d 25 (9th Cir. 1967), affirming 252 F. Supp. 623 (D. Ariz. 1966), upon which respondent principally relies, does not dictate a contrary result. In that case, the Securities and Exchange Commission sought to invalidate the merger of two stock life insurance companies on the ground that the anti-fraud provisions of the Securities Exchange Act of 1934 were violated. The District Court merely held that application of the Federal Act 'would at least "impair," if not "invalidate" or "supersede" an Arizona statute enacted for the purpose of regulating the business of insurance, which contains the specific requirement that any proposed merger of insurance companies must be approved by the state director of insurance. (252 F. Supp. at 626). The Court of Appeals noted that the State of Arizona had 'affirmatively asserted its power to regulate the merger of insurance companies' (387 F.2d at 31) and that the legislative history of the 1964 amendments to the Securities Acts indicate that the States were to be given an opportunity to demonstrate their ability to effectively protect the investors as well as the policyholders.' (1964 U.S. Code Cong. & Admin. News, p. 3022, quoted in 387 F.2d at 31, n. 3). The Court of Appeals, therefore, affirmed the District Court's holding that application of the Securities Exchange Act of 1934 would impair, invalidate or supersede the Arizona law. (387 F.2d at 32). The Court did not hold that the Securities Exchange Act of 1934 was inapplicable for the reason that it does not contain a provision making it applicable to insurance. *What National Securities, Inc. did hold was that the federal statute did not govern because it impaired a detailed state regulatory scheme specifically and directly aimed at the insurance business.*" (Emphasis added.)

with a rhetorical question for the SEC: How would it be possible more completely to impair or supersede the Director's power than to set aside a merger he allowed? If the SEC did wish to impair or supersede A.R.S. § 20-731, what else could it do?

IV. *Proxy Solicitations for a Merger are not Covered by § 10(b) of the Securities Exchange Act of 1934 or Rule 10b-5.*

This is an action to nullify a merger, allegedly because of improper proxy solicitations, brought under § 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 issued under that Act. The 1934 Act gives the Commission a mighty arsenal of weapons, and not all of them are in any one section or in any one rule. Rule 10b-5 deals with certain frauds in the purchase and sale of securities. On their face, neither the statute nor the rule deals with proxy solicitation at all. The proxy section is § 14(a) of the Act, 15 U.S.C. § 78n, and Rule 14a(1) through (12), of which Rule 14(a)(9) deals with misleading statements. Section 14 of the Act as it appeared prior to the 1964 amendments made it a violation of the Rules of the Commission to solicit proxies "in respect of any security . . . registered on any national securities exchange." No security of either of the insurance companies here involved was registered on a national exchange, and therefore the Commission could not and did not attempt to assert jurisdiction under the proxy rules.

Section 14 was broadly extended in 1964, 78 Stat. 565 (App. to this brief).²³ The amendment, which by virtue of SEC Regulation 12h-1, 17 C.F.R. 240.12h-1, took effect with respect to insurance companies in 1966, extended proxy controls to companies whose securities are sold over-the-counter, but exempted insurance

²³ The principal effect of the Securities Acts Amendments of 1964 flows from the addition to § 12 of the 1934 Act of subsection (g)(1) which requires registration with the SEC by any company having total assets exceeding \$1,000,000 and more than 500 holders of any class of its equity securities (15 U.S.C. § 78l(g)(1)). At the same time § 14(a) of the 1934 Act was amended to make the proxy rules applicable to any company registered under § 12 (15 U.S.C. 78n(a)).

companies where a substantially equivalent state regulation is in effect (78 Stat. 565, 15 U.S.C. § 78l(g)(2)(G), App. to this brief). Upon the passage of the 1964 Act, the National Association of Insurance Commissioners prepared uniform proxy regulations for use by the insurance commissioners of each state, and all fifty states have now adopted either regulations or statutes to this general effect; see 2 CCH Fed. Sec. L. Rep., para. 23, 310. For example, Arizona adopted a statute which referred explicitly to the 1964 amendment and authorized appropriate issuance of proxy regulations, A.R.S. § 20-143. The Insurance Director promptly issued general Rule No. 66-12 ("Regulations Regarding Proxies, Consents and Authorizations of Domestic Stock Insurers"), a detailed regulation of some 5,000 words.

Once again, the Government sees the issue differently. The Government says "§ 10(b) is directed against fraud in connection with the purchase or sale of securities, whether or not such fraud involves a proxy solicitation" (SEC Br. p. 30). We say, just exactly how does § 10(b) cover proxy solicitations at all? The Government has cited no cases either in the lower courts or here supporting the proposition that § 10(b), rather than § 14, reaches proxy solicitations in any way, and so far as we know, there are no such cases. The only two cases prior to this one dealing with the subject either hold or suggest that § 14, which is expressly the proxy section, rather than § 10(b) is the appropriate section for proxy control. In *Borak v. J. I. Case Co.*, unreported in the District Court, *rev'd on other grounds*, 317 F.2d 838 (7th Cir. 1963), *aff'd*, 377 U.S. 426, 84 S. Ct. 1555 (1964), the District Judge said:

"... The facts which plaintiff alleges as constituting a violation of § 10b, that is the soliciting of proxies by means of a proxy statement containing false and misleading statements and omissions of fact, constitutes, if true, a violation of § 14a and not of § 10b. It is § 14a and not § 10b which protects the

stockholders right to full and fair disclosure in corporate elections by proxy."²⁴

See also *Barnett v. Anaconda Co.*, 238 F. Supp. 766, 776 (S.D.N.Y. 1965), saying: "Section 14(a) is specifically designed to deal with deceptive proxy material and consequences flowing therefrom. There is nothing here to justify any contention that 10(b) and Rule 10b-5 and § 17(a) provide enlarged or different remedies for what are merely violations of § 14(a)."²⁵

The 1964 amendments are expressly based on a special study by the Commission, of which the relevant portion is House Doc. No. 95, pt. 3, pp. 40-41, 88th Cong., 1st Sess., in which the Commission dealt, among other things, with the need of coverage of insurance companies. In its discussion of proxy materials as they relate to insurance companies, the Commission expressly asserted that the proxy materials used in connection with such companies were inadequate by Commission standards. The Commission said:

"In 15 instances, matters other than election of directors are to be voted on—*mergers*, options, retirement plans, etc.; there was not one solicitation which contained information approaching that required by the Commission proxy requirements."

(Emphasis added.)

Again, in the statement made by SEC Chairman William L. Cary, before the Senate Committee on Banking and Currency, various statements of the Commission itself were presented. One of these, a statement by the Commission staff relating to § 14, expressly cited mergers as illustrative of the need for broadening the proxy controls; see *Federal Securities Law Reports*, CCH, No. 905, pt. 1, June 20, 1963, p. 89.

²⁴ Unreported opinion deposited with the Clerk of the District Court in this case.

²⁵ In the instant case the District Court seems to suggest, but did not decide, that he thought § 10(b) inapplicable to proxy solicitations; see App. 141.

Why did the Commission tell the Congress that it needed to amend the Exchange Act to make the proxy rules applicable to mergers of over-the-counter companies if it already had that power under § 10(b)?²⁶ If, as it now contends, it has power over this subject matter under both sections, surely it was disingenuous not to have acknowledged it to the Congressional committee.

We offer the argument based upon § 14(a) and the 1964 amendment for two purposes:

(a) The inapplicability of § 10(b) to proxy solicitations is an independent ground for affirming the decision of the court below, quite apart from the McCarran Act;

(b) The scrupulous care with which Congress left proxy regulation to the states in connection with the 1964 amendments is further evidence of the McCarran Act policy of Congress. As the opinion of the Court of Appeals shows by quotation from the House Committee Report, the exclusion of insurance companies from proxy control by the SEC avoided "departure by the bill from the doctrine embodied in the McCarran Act that regulation of insurance companies be left to the states."

V. *The Writ of Certiorari was Improvidently Granted.*

There is no suggestion that there is another case in America involving proxy solicitations for a merger of insurance companies.

²⁶ The proxy problem interlocks very closely with the "no sale" problem. In 1941, when Congress was considering whether to extend § 10(b) to mergers by broadening the concept of sale, the bankers, security dealers, and exchanges advised that this was unnecessary because the § 14 proxy rules would apply "in the case of mergers, consolidations or reorganizations" for "all corporations who have securities registered on a national securities exchange." (Hearings on H.R. 4344, H.R. 5065, and H.R. 5832 Before the House Comm. on Interstate and Foreign Commerce, 77th Cong., 1st Sess., pt. III, at 846, 848 (1941).) This was quite true as to those corporations. The statement continues with direct reference to mergers, enumerating all the proxy requirements which the SEC in the instant case seeks to impose under § 10(b) but which were there said to flow from § 14. The 1964 amendment did extend § 14 to the class of companies earlier excluded—but conditionally exempted insurance companies.

If such a case arose, it would now clearly be governed by the 1964 Act, for every state has now adopted regulations pursuant to the 1964 amendment. We appreciate that there are substantial questions in this case which could be decided, as for example the "no sale" issue or the McCarran Act issue or the scope of 10(b) as it relates to proxies. But in the circumstances all of these determinations are advisory, for however they are decided, any future similar case will involve first and foremost the new proxy statute. While we realize that this Court has more than tentatively decided that the matter is important by granting the writ of certiorari, we suggest that upon closer acquaintance after oral argument, this is an appropriate case for dismissal of the certiorari; see for collected authorities, *R. Stern & E. Gressman, Supreme Court Practice* 190-93 (3d ed. 1962).

CONCLUSION

It is respectfully submitted that the judgment of the Court of Appeals should be affirmed.

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